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Market Dynamics vs. Fundamentals

> **"It is not so much the folly of the ordinary man who played the market during the stock exchange boom as the folly of those to whom he looked for advice and guidance which is most striking. In some cases of course this was more, or worse, than folly. Many of those who offered advice, nearly always in the direction of increasing already exaggerated expectations, were personally interested in the continuation of the bull market; but since in most cases they followed their own advice, they could hardly be accused of deliberate deceit."**
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> **— Goronwy Rees, *The Great Slump*, 1970**
> **Weidenfeld & Nicolson, London**

It has been an exceptional month. Though not surprising, Labor has taken the helm in England. The Japanese yen has started its comeback with a bang. In Europe, its two eminent leaders, President Chirac in France and Chancellor Kohl in Germany, have embarked on their political self-destruction by badly bungling their affairs.

Conventionally, it is argued that the German and French people refuse and resist any austerity. We see this very differently. What has to be realized and ought to be blamed in the first place is the gross ineptness of the political leaders in the two countries to convey the exigency and urgency of such measures in order to revive employment and economic growth.

In Asia — where we focus our analysis this month — the revival of Japan's economy and currency compel to the reassessment of the huge speculative ploys with the ultra-cheap yen. Additionally, the festering problems in the Asian Tiger countries are roiling regional financial markets and currencies.

In the United States, with the Fed standing pat and signs of moderating growth augmenting, euphoria of equity investors has returned with a vengeance. And while the dollar's spate of weakness, along with rumblings of hedge fund liquidations of U.S. Treasuries in an apparent unwind of yen-carry trade, draws some concern, turbulence in Europe and Asia seem to leave America as the safe haven in the world.

As to U.S. stocks, our attention is increasingly focused on the unprecedented market dynamics. With the preponderance of highly leveraged derivative products and strategies, and with vast masses of speculative capital playing the U.S. market, rather inconsequential news and economic data can lead to truly breathtaking price moves. We are struck by the return of optimism towards the lagging small caps, which have somewhat narrowed the gap created by their underperformance.

In particular, we must admit our disbelief at the incredible rally experienced by the technology sector. While the unwind of derivative hedged and bearish positions, as well as a general short squeeze, have certainly been major factors in the rally, Wall Street has clearly stoked the speculative frenzy with exceedingly bullish assessments. Taking a global view of issues confronting this industry so vitally important to the U.S. economy and, of course, to Wall Street, we believe a much more cautious approach is appropriate. With the Dow and S&P500 rallying to record highs as the NASDAQ composite and Russell 2000 lag badly, the question becomes: Is this an ailing market where cautious investors and mutual fund managers resort to focusing on the liquid blue chips that can be sold quickly at the first sign of trouble or will the market broaden bullishly to reward the

majority of investors that have so far experienced a less than stellar 1997?

Certainly, many small caps have had significant rallies, but the most spectacular gains have been, not surprisingly, in stocks with large short positions. The technology sector, having attracted a considerable bearish contingency, has seen a truly extraordinary rally. The Morgan Stanley High Tech Index (MSH) and the NASDAQ 100 (NDX) have posted four-week gains of 22 percent and 16 percent, quickly reaching record highs. The bears, which had recovered some of their losses and much of their hope, have been crushed once again. The semiconductor stocks, a prime target for fundamentally oriented short-sellers, has been one of the strongest sectors, posting incredible gains of 32 percent so far in 1997.

We see two factors in particular which combine to create today's disjointed nature of trading on Wall Street.

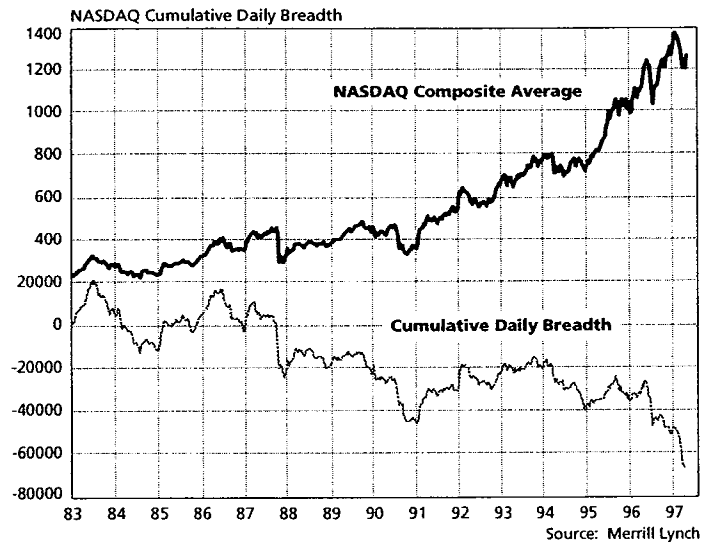
First, there has developed a huge pool of speculative money employing a "hedged" strategy, with funds investing long while simultaneously shorting fundamentally weaker companies. These operators also commonly use derivatives for leverage and tend to trade aggressively, increasing their bearish bets during market weakness. But when the stocks rally instead, they urgently cover shorts and unwind their bearish "hedges."

Second, there has developed an unprecedented embracement of derivatives throughout the marketplace both for hedging and for speculating, with accompanying aggressive trading dictated by these sophisticated strategies.

Indeed, we see these factors as the dominating influences in the market. The widespread use of hedging and derivatives account for the market's direction and its wild gyrations, as the aggressive speculators and derivative operators wage a vicious bull-versus-bear "tug-of-war", a battle that has up till now been won by the bulls.

What keeps us skeptical, however, is the continued unimpressive performance of the vast majority of stocks. While the Dow and S&P500 have year-to-date gains of 13 percent and 33 percent respectively, the small stock Russell 2000 index has risen only two percent. In fact, the Russell 2000 remains only one percent above its high in June of 1996. Furthermore, the Investors Daily Mutual Fund Index has a year-to-date gain of only two percent. When the Dow hit a record high of 7,333 on May 15th, only 116 (four percent) stocks on the New York Stock Exchange Index hit new highs, compared to 343 (12 percent) on February 13th, when the Dow traded at 7,022 — then a record. Interestingly, even the technology sector, with the indices posting strong advances, has seen lackluster gains from most stocks. With the Morgan Stanley High Tech and the NDX trading at or near record highs, the percentage of stocks within these indexes trading at highs is only 30 percent and 28 percent, respectively.

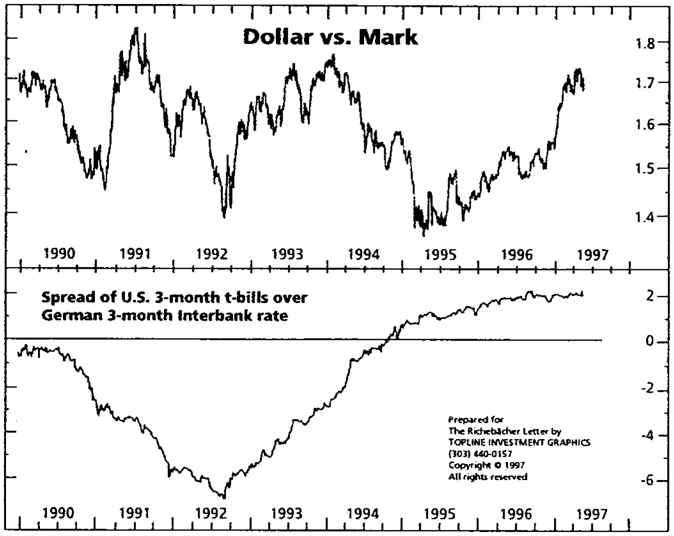
WHERE THE INDICATORS STAND

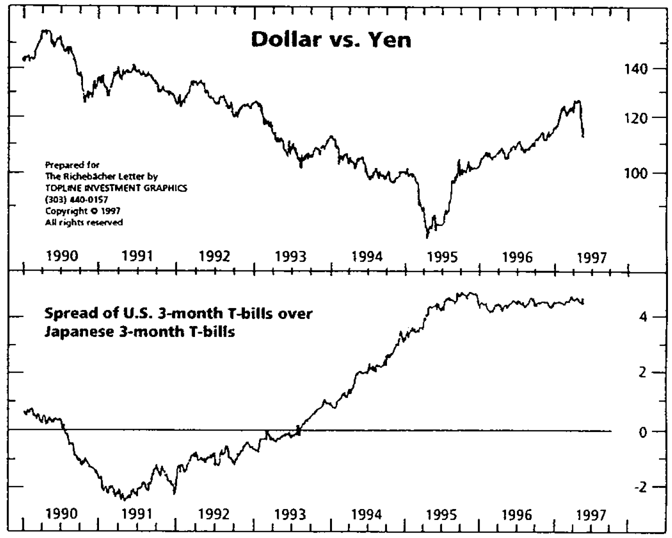


Source: Merrill Lynch

YEN-DOLLAR RAMIFICATIONS

Another important group hinting of a less-than-bullish market environment is the financial sector, and specifically the money center banks. While festering problems in the consumer debt area have hammered many aggressive lenders, we suspect recent nervous trading in the major financial institutions reflects growing





concern related to the global ramifications of a potential unwind of the yen carry trade.

For several years now hedge funds and international banks, among others, have profited handsomely by borrowing yen or Swiss francs at very low rates to purchase higher-yielding bonds in other currencies.

Similar to the U.S. domestic carry trade in 1992-93, it is simply impossible to know the size of these speculative positions or the consequence of the eventual unwind. However, considering the number and size of the institutions that have been playing this speculation, and the length of time that is has been available, one should assume that there is considerable potential for unstable conditions impacting the international currency and credit markets, with ominous consequences for the overheated and vulnerable U.S. equity market.

Beyond macro-economic issues, in our view, there just seems such a wide gap between investors' overly bullish perceptions of the general environment and the less sanguine reality at most individual companies. This, not surprisingly, is true for both earnings prospects and stock price performance where the majority of companies underperform bullish expectations. And nowhere is this more apparent than in the technology industry.

While company after company throughout the sector disappoint investors, a few of the high-profile companies do exceptionally well, thus maintaining the perception of broad industry health. This is certainly a prime explanation of the narrowness of the market and the dramatic rises experienced by the small group of strong performers. As money pours into the market, albeit at a slower place than earlier in the year, fund managers are increasingly throwing money at the favorites. While this perpetuates bullish perceptions, it is certainly not the type of market environment that we find very encouraging.

YEN — FLUKE OR COMEBACK?

The abrupt surge of Japan's yen was an accident waiting to happen because with its almost invisible short-term interest rate around 0.5 percent it had become the world's key currency for highly leveraged financial speculation in high-yielding American and European bonds — the famous yen carry trade. Consequently, the world had become hugely short yen. Indeed, this yen carry trade ploy played a crucial role in pushing the dollar higher and higher. But in order to net the full interest rate differential of five percent and more on foreign bonds, the speculators had to abstain from covering their yen liabilities.

In this light, it was always clear that the dollar was in for an instant vertical plunge, once this speculative bubble would be pricked. Essentially, the highly sophisticated speculators, heavily involved in this game, would rush either to hedge their yen exposure by buying forward yen, allowing them to stay put with their holdings in foreign bonds, or to unwind their whole yen-financed positions, buying spot yen and liquidating their holdings in foreign bonds. While there never could be the slightest doubt about this final outcome, its timing was open.

Just that has happened, only much earlier than had generally been expected. Actually, it took little more than a week to wipe out what the dollar had gained against the yen over the prior six months, and all it needed to do that was an ambiguous remark about the dollar-yen rate by Mr. Sakakibara, alias Mr. Yen, director-general of the Japanese ministry of finance and outspoken advocate of higher interest rates.

When the finance ministers and central bank governors of the G7 industrial countries first jointly expressed their displeasure with the rising dollar on February 8 at their meeting in Berlin, nobody had listened. There is, anyway, little esteem in the currency markets for central bank interventions in the absence of policy changes, least of all for purely verbal interventions. What's more, there was a general, strong supposition that this pronouncement was more pretending than truthful. Strikingly, the Bank of Japan, although sitting on a war-chest of more than $200 billion of foreign-exchange reserves, had not used any of it to prop up the yen.

Economic reason, rather, said that the strong dollar suited all parties concerned. For America, it not only reduced the risk that the robust domestic demand growth might spill over into higher inflation for goods and services, associated currency gains on the dollar also added to the attraction of U.S. financial assets for foreign investors. On the other hand, the weaker yen and D-Mark were helping to spur output in the feeble economies of Japan and continental Europe.

Yet, the G7 finance ministers came back to their pronouncement about the dollar at their meeting on April 28 in Washington, with perceptibly tougher words. But as the possibility of massive official intervention still appeared a mere wisp of a threat, the markets again greeted it with something of a yawn. Meanwhile, more and more brokers and banks had switched to longer-term dollar bullishness, arguing that its recent gains were firmly underpinned by economic fundamentals.

After all, the needle that punctured the bubble consisted of nothing more than the cryptic remark by Mr. Sakakibara suggesting that the dollar might easily fall to 103 yen, after a peak of Y 127 on May 1. Within barely ten trading days the dollar dropped in a straight line to Y 112. Better proof of the dubious nature of its prior steep rise against the yen is hardly feasible.

How times change. Only two years ago, the dollar was in free-fall, while yen and D-Mark soared to record-highs. From its lows of Y79 and 1,37 DM in the summer of 1995, the dollar gained more than 50 percent against the yen and more than 20 percent against the D-Mark. How is it possible that the U.S. dollar, after ailing and falling for more than two decades, can experience such a dramatic metamorphosis within such a short span of time? But how much of this is cyclical and temporary, and how much structural and secular? That's the big question.

THE DOLLAR'S DECEPTIVE STRENGTH

True, the U.S. economy has been outperforming all other industrial countries while at the same time offering some of the developed world's highest interest rates. Aren't these compelling reasons for a fundamentally strong dollar? No, not if the resulting strong GDP growth reflects loose money and excessive borrowing, for which the trade balance is the infallible indicator. As we shall explicate in this letter, the dollar owes its strength in the last

two years not to ordinary private capital inflows but to two absolutely abnormal financial flows crossing the exchange markets: yen-carry trade and massive dollar reserve accumulation by foreign central banks.

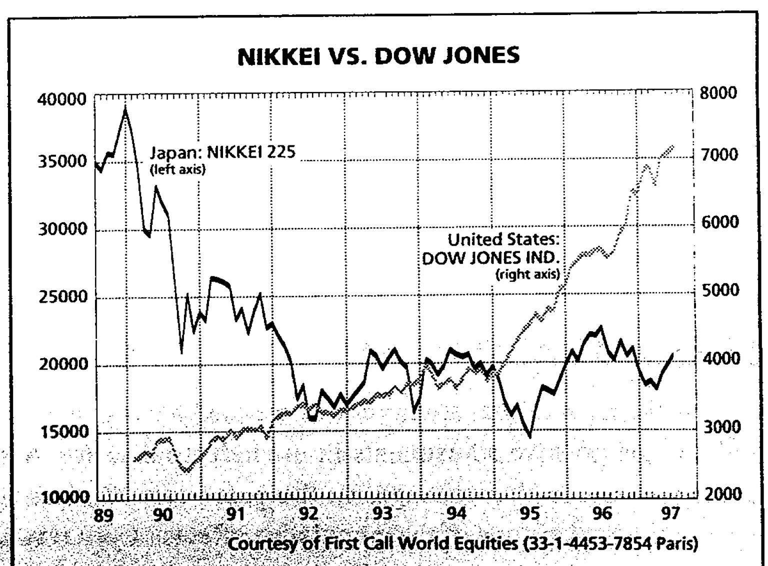
Back to the dollar's recent plunge. It all started in late 1996, early 1997 with the sharp fall of the Tokyo stock market from a November peak of 21,418 to a January low of 17,303, after the Japanese government had announced a sharply contractionary 1997 budget. Consisting of substantial spending cuts in association with a consumption tax hike of two percent and the abolition of a temporary income tax break, these planned measures add up to an estimated subtraction of about 1.6 percent from GDP growth in the current year. Following right on the heels of massive fiscal expansion in 1996, it was widely assumed that this drastic reversal in fiscal policy would derail the moderate recovery and slash economic growth in 1997 to just 1.5 percent after 3.6 percent in the previous year, implying the prolonged maintenance of loose and cheap money — and consequently a still weaker yen.

JAPAN'S DOLLAR DILEMMA

Faced with this supposedly dismal economic outlook for Japan's economy, a great pondering began in the markets about what the Japanese authorities could and would do to soften the heavy blow of fiscal tightening and to keep the economy going. With interest rates already at a rock-bottom level, many foreign investors concluded that the Japanese authorities had for this purpose no other weapon at their disposal than to manage or to allow a further decline of the yen in conjunction with loose money.

Ordinarily, a weakening currency is bullish for business profits and the stock market of that country. In Japan's case, however, it might work in the opposite direction by scaring away foreign investors, who in the past five years had been the market's mainstay, as against heavy net selling by Japanese investors. Confronted with the prospect of both a weaker economy and further currency losses, frightened foreigners began to unload stocks, provoking the simultaneous fall of the yen and Japanese equities. Just as the weak dollar had threatened the Japanese-supported U.S. financial markets in the late 1980s, so the weak yen now threatened the U.S.-supported Japanese stock market in the 1990s.

If the Japanese authorities, however, might have liked the benefits from a falling yen for the economy, they are much more afraid of its destabilizing effects on their stock market. The banking system, still groaning under the mountain of bad debts, could definitely not afford a lengthy plunge in stock prices, playing a key role in the fulfillment of the international capital adequacy rules for banks. A sharp fall in stock prices might have developed into a full-blown banking crisis.



More compelling for Japanese authorities to stop the rot of the yen are worries about the still sizable U.S.-Japanese trade imbalance. So far, U.S. government officials were quiet on this issue, but Deputy Secretary of the Treasury, Lawrence Summers, broke that silence in early March by stating that the U.S. government would not tolerate a new widening of Japan's trade surplus and that Japan should counter it by new fiscal stimulation. Many U.S.-Japan trade issues that had been kept

under cover over the past ten months owing to electoral considerations were raising their ugly heads again.

Given the Japanese determination to cut their budget deficit rather than to expand it, they had to offer and attempt an alternative solution for the trade threat, and that essentially is a stronger yen. But we all know that governments cannot simply command the behavior of currencies in opposition to underlying market forces. A lasting change in currency trends requires a corresponding change in policies and market forces.

FIXATION ON THE TAX BOGEY

Actually, key economic indicators for the Japanese economy have since last October been showing accelerating growth. Yet despite all the good news, consensus forecasts remained extremely pessimistic. All the reasoning was fixated on the impending consumption tax, which would supposedly advance spending from the second quarter of 1997 into the prior quarters. In this light, any better-than-expected growth before the implementation of the tax on April 1, 1997 was interpreted as meaning that the tax had a bigger shift-effect than previously thought, implying all the weaker growth afterwards.

Apparently, the Japanese authorities have decided that there is more to the economy's recent strength than just the temporary shift-effect. The trade balance, in particular, indicates a sea change in the fortunes of Japan's economy. The impact of net exports on GDP growth has in the course of 1996 turned from substantially negative to substantially positive, lifting real GDP growth in the fourth quarter of 1996 at an annualized rate of 1.6 percent, after having curtailed it in 1995 by one percent. What's more, the rate of improvement during the year has been dramatic.

THE BIG J-CURVE DECEPTION

According to the official trade statistics, Japan's trade surplus has in the last three years plunged from yen 15.4 trillion in 1993 to yen 9.1 trillion in 1996. No improvement seemed in sight, although the plunging yen had drastically raised the competitiveness of Japanese manufacturing. To most observers, this failure of trade to respond to the declining yen only confirmed the prevailing, all-pervasive pessimism about Japan's ailing economy.

In reality, Japan's trade balance had already since mid-1995 rather promptly reacted, but its reversal was for almost two years masked by the whopping price effects — the famous J-curve effect — from the drastic yen devaluation that translated declining import volume into soaring import values. At the end of 1996, import prices were up 16.4 percent year on year while import volume was down 2.6 percent. In other words, all of the continuing trade deterioration came from price effects.

Trying to probe the prospects of Japan's economy and currency, it appears essential to distinguish between two adjustment processes: first, the restoration of a viable banking system and its release it from the ravages of bad loans; second, the restructuring of the industrial sector, associated with the disposal of the massive, bubble-related overinvestments and malinvestments.

DRASTIC INDUSTRIAL RESTRUCTURING

It seems to us that attention was focused too much on the intricate bad loan problems of the banks and too little on the positive adjustments in the industrial sector. Actually, Japan's industrial and trade structures have undergone tremendous changes in the past years. Outstanding key features of this restructuring were: first, against the background of the cumulative effects of yen revaluation and trade friction with America and Europe, a rapid expansion in overseas investments and production; second, a substantial shift in domestic industrial

investment and production away from labor-intensive consumer durables and toward capital- and technology-related products along with a corresponding transformation of the export and import structure which includes a replacement of the decline in exports with foreign direct investment; third, a drastic shift in global investment, production and exports towards the strong-growth East Asian countries.

A few figures may give an idea of the extent of the industrial restructuring: Since 1990, the ratio of consumer durables to total exports has decreased from 25 percent to 15 percent whereas the ratio of capital goods to total exports rose from 54 percent to 62 percent. Car exports declined from Y 7.6 trillion to Y 5.1 trillion. On the other hand, imports of machinery and equipment, largely high tech, virtually doubled during this period.

Or another striking feature: Between 1992-96, Japan's overall exports experienced a moderate gain of 1.7 billion yen, or four percent. But this was the net effect of two extremely divergent regional developments. While exports to Asia soared by 4.8 billion yen, or 33 percent, exports to America and Europe declined by 3.1 billion yen, or 11 percent. The share of Asia in Japan's overall exports rose in this period from 34 percent to 44 percent.

FOR SURE: IT'S A COMEBACK

All in all, Japan's economy presents a complex and confusing picture, reflecting a tug-of-war between strengthening and weakening influences that are difficult to quantify. We are convinced that the government's astronomic deficit spending, resulting in a swing in the budget balance from a surplus of three percent of GDP in 1991 to a deficit of almost five percent of GDP in 1996, has effectively done more harm than good. But more importantly, from a long-term perspective the industrial sector has implemented formidable structural changes that have immensely strengthened its competitiveness, after temporarily boosting imports and restraining exports.

Trying to look ahead, the safest thing to say is that Japan's trade surplus is on the verge of ballooning. The major primary effect will rapidly accrue from sharply lower import prices provided by the depreciating dollar on Japan's imports. This will reverse the J-curve effect on the trade balance. The second, more gradual, major upward push to the trade surplus will come from further volume improvements in foreign trade. Yet the speed with which the dollar has fallen is certainly not to the liking of the Japanese authorities.

For us, the key test of an economy's future growth and health are always its savings and investment ratios. Importantly, the bubble excesses have not harmed Japan's excellent savings and investment fundamentals. Both remain far in excess of corresponding levels in the United States and Europe. Despite soaring overseas investments, domestic fixed investment has continued at its record levels of around 28 percent of GDP, as against 18 percent in Germany and France and 17 percent in the United States.

THE U.S. HOUSE OF CARDS REVISITED

Possibly, Mr. Greenspan had helped a little bit to weaken the dollar by his comments which had assuaged the prevailing fears of imminent further monetary tightening. Referring to the March hike as a form of "insurance", he apparently indicated his response to recent signs of U.S. economic moderation. Indeed, he has been predicting that the economy would settle in at modest growth for the rest of 1997.

In the last issue of this letter we said, "We regard the U.S. economy's present strength not as a new trend but as a temporary aberration. In accordance, we don't see a possible sequence of further rate hikes. Rather, the Fed is going to stay as loose as ever. The economy will lose steam on its own. The extent and speed of its decline

will heavily depend on the performance of the stock market, which equally is much weaker than it looks when measured by popular stock indexes."

In particular, the house of credit cards is looking flimsier than ever, thanks to overzealous lenders and desperate borrowers. Credit card debt has almost doubled since 1995. Charge-offs at 6.72 percent of outstanding aggregate loans are at their highest level since June 1992. But back then, it was a time of recession. Now the economy is booming.

Though the U.S. economy has in the recent months surprised by its sharp acceleration, we have always doubted its sustainability. As explained in past letters, this U.S. economic expansion is chiefly driven by two specific booms; booming consumption and booming high tech. All other GDP components, such as government spending, housing, foreign trade and other kinds of investment spending, are distinctly weak.

As to the consumption spree, it has obviously been fueled by the incursion of record debts and increasing willingness to spend against the wealth effects of soaring asset prices. Installment debt is up a staggering 53 percent in the past four years. But soaring delinquency rates and sliding debt growth — down to 2.0 percent in March — meanwhile suggest growing trouble for the many households, which own few assets and depend heavily on the expensive installment credit. That part of the consumption boom really seems to be at its last gasp.

It essentially must be the wealthier households, which have taken over in the spending frenzy, inspired by the booming stock market. In the consensus view, the consumer spending binge is solidly underpinned by gains in jobs and wages. Income growth, however, depends on spending growth. Spending, either by consumers or businesses, leads, and income follows. To increase their spending, consumers and businesses alike have either to borrow or to draw on their cash balances — both of which the American consumer has done with a vengeance. We wouldn't' t call this a healthy and sustainable source of economic growth. Once the stock market boom, like the borrowing binge, runs out of fuel, it will precipitate a disastrous mess in consumer finance.

HIGH TECH — THE OTHER GDP PROPELLANT

What about the high-tech motor? Though accounting only for five percent of U.S. GDP, it provided in the last two years 27 percent of GDP growth, 38 percent of total profit growth, and 20-25 percent of total wage and salary growth. Total capacity expansion has been driven almost entirely by capacity growth in the high tech industries, expanding at about 40 percent per year compared with 1.5 percent in the rest of the manufacturing sector.

In this light, we therefore said in the last letter, "Keep your eyes on high tech news and high tech stocks. It has been crucial in propelling both the economy and the stock market boom." In the same vein, the further staying power of this high tech boom is now the crucial question concerning the well-being of the economy as well as that of the stock market.

Various U.S. stock market indices have recovered to new highs. The high tech sector has also rebounded strongly. But only the big cap issues: IBM, Intel, Microsoft, etc. have made new highs for the year. Numerous other, generally small-cap stocks have modestly rallied from their previous carnage. Does this indicate an improvement in high-tech's prospects?

Unfortunately, there is a plethora of data presented by the companies but a dearth of aggregate statistics

that track the trends in the industry. The management of many companies bend over backwards to put deteriorating data into a rosy light. On the other hand, there is an increasing number of articles from PC industry professional discussing a serious slowdown and possible recession in the industry.

Since our faith in corporate pronouncements is very much on the low side, we prefer to rely on outsider reports, and they are more or less bearish. An outstanding example of obvious corporate misinformation is the case of IBM, about which we have repeatedly reported. For example, shares of IBM have recently continued to outperform the market — despite sluggish sales growth for the first quarter. The rise in IBM's share price was due, once again, to largely one-off factors not related to improvements in sales or productivity: in this case, a reduction in the company's tax rate, a dividend increase, and two stock buybacks.

Generally speaking, there are two considerations that above all make us lean toward this bearish side. First of all, common sense tells us that the exorbitant, high double-digit growth rates in high tech in the recent two years, both in capacity and demand growth, are simply unsustainable over time. Second, we note that the bad news about U.S. high tech has its parallel in bad news about continued oversupply in the electronics industries of the Far Eastern countries, as reflected in a widespread collapse of exports....

HOW STRONG IS THE DOLLAR REALLY?

Frankly speaking, we are not sure whether the Fed's decision to leave short-term interest rates unchanged ought to please or displease us. The fact that it complies with our prediction does please us, of course. Yet we doubt that this is the appropriate gauge for good or bad policy.

Our prime considerations were the expectation of a sharply slowing economy and the impression that Mr. Greenspan is overcautious, when it comes to tightening. Apparently, his maxim is, "When in doubt, do nothing." This is in contrast to the Bundesbank's principle, "When in doubt, raise rates." Besides, we wonder what is really Mr. Greenspan's greater concern — to avoid a major setback in the financial markets or to avoid inflation in consumer and producer prices?

As a matter of fact, we doubt in the first place that a mini-rate hike of 0.25 percent barring any complimentary tightening measures deserves all the fuss being made about it in the financial and currency markets. To have any restraining effect on consumers and producers, it would need a lot more. Equally, it is farfetched to think that such a minimal move would suddenly pull in zillions of dollars in foreign currency.

Our strong dissent begins with the American habit of relating inflation exclusively to rising consumer or producer prices. Looking at the unchecked U.S. internal and external money and credit flows, it is our long-standing position that the United States has presently perhaps the most rampant inflation in its history. But in the existing global environment of substantial underutilization of capacities in the rest of the world, this inflation finds its outstanding manifestations in the swelling trade deficit and the booming financial markets, rather than in the conventional price indexes.

The usual counterargument is that the trade deficit is ever so small in relation to almost $8 trillion of GDP. But this compares a flow with a stock. In order to grasp the overriding importance of the trade deficit in suppressing U.S. inflation, it has to be seen in relation to current spending and GDP growth.

Here are the relevant facts: during the five years since 1991, when the present cyclical U.S. recovery started, the United States has racked up a cumulative current-account deficit of $624 billion. This compares with simultaneous nominal GDP growth of $1.66 trillion. In combination, the two aggregates add up to an increase

in total domestic spending by $2.29 trillion, of which a phenomenal share of 27 percent was met by imported goods and services in excess of exports.

Every fourth incremental dollar spent in the United States on goods and services, in other words, has been spent abroad. U.S. domestic demand inflation has a tremendous leakage into imports. That, and nothing else, has been holding U.S. inflation rates in check. Forget about the wisdom of Mr. Greenspan, and forget also about a miracle in productivity growth as the source of low U.S. inflation. The simple truth is that America exports its inflation.

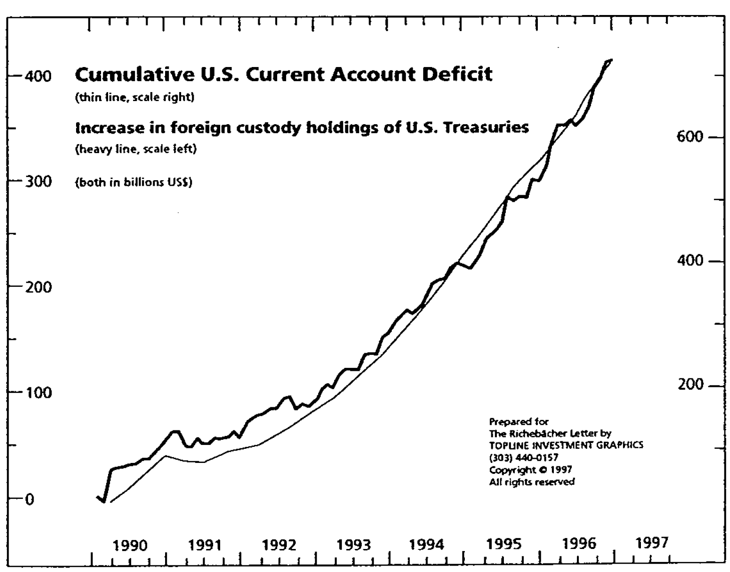
It must be realized that there is nothing that more powerfully suppresses inflation than a big import surplus. That is, it impacts the inflation rate from two sides. On the one hand, it enlarges the supply of goods and services; on the other, it siphons off a corresponding amount of domestic incomes and money balances and channels them abroad. To maintain economic growth all the same, it requires permanent monetary looseness that more than offsets this import-related drag on incomes and money supply. Obviously, the Fed has so far successfully obliged.

Until the early 1980s, before America began to run its rising, chronic trade deficit, the ruling influence of the trade balance on inflation used to be commonplace knowledge among economists. Actually, it was at the center of the gold standard concept. Unusual in the current situation is only that the United States has been able to run such a big external deficit for so long without greater harm to its currency.

What, then, has been keeping the dollar strong? According to the conventional bullish view, the dollar's strength has its roots in the existing growth and interest differentials between the United States and the other major industrial countries, attracting more than sufficient capital inflows from abroad to finance and even overfinance the U.S. current-account deficit, however huge it is.

THE TWO ODD FLOWS THAT BUOY THE DOLLAR AND U.S. FINANCIAL MARKETS

The trouble with this dollar bullish concept is that its advocates conveniently refuse to scrutinize those capital flows, though their exceptional nature is well-known in the global financial world. They are of two kinds: first, dirty float operations by foreign central banks involving massive dollar purchases which are largely invested in U.S. Treasury paper; second, record high buying of U.S. dollars and U.S. Treasuries from the tax haven countries of the Caribbean, reflecting highly leveraged carry trade with ultra-cheap yen or Swiss francs. Many U.S. hedge funds are domiciled there.



It is brazenly obvious that both kinds of capital flows dominating the U.S. capital balance during the last three years definitely do not rank as ordinary market forces. Given their exceptional character and magnitude, they must essentially be regarded as exceedingly distortive market influences with pervasive effects on the whole of the U.S. financial system.

Having this cleared up, we are able to answer our earlier question about the origin of the dollar's

strong rebound over the last two years: cyclical or fundamental? The answer is: neither. The two main flows that we have identified as the dominant forces behind the dollar's rebound — yen-carry trade and central bank purchases — are related to special circumstances prevailing in Japan and the Tiger countries.

Plainly, these two flows have had four main effects: first, they artificially lower U.S. interest rates; second, they sponsor the stock market boom; third, they boost the dollar; and fourth, they permit the Fed to keep its monetary stance extremely loose irrespective of any currency considerations. But, in the final analysis, this monetary looseness feeds the huge, chronic current-account deficit and persistent huge capital outflows.

We have often stressed that in the absence of the yen-carry trade and the massive dollar purchases by foreign central banks the situation in the world financial markets would be utterly different. Both the dollar and the U.S. bond market would have crashed, to be sure also with devastating effects on the stock markets. In this light, everything now boils down to the one question: how long can these two odd flows continue?

Again, we must distinguish between the two flows: yen-carry trade and foreign central banks.

As to the first, it appears unquestionable that the game is largely over. Unwinding of the positions essentially depresses both the U.S. dollar and U.S. bonds. How much of this unwinding has already taken place, and how much is still in store, nobody knows. In any case, it will certainly impinge on global bond markets.

As for the second flow, it is still an open question as to how long this can continue, but there are currency disturbances in the Far East that may answer that question soon.

CURRENCY BATTLE IN THE FAR EAST

At the same time, the big dollar and Treasury purchases by the Asian central banks have been interrupted by regional currency turmoil, involving primarily the Thai bath. But as many of Thailand's excesses (overinvestment, bad loans plaguing the financial system, high indebtedness in foreign currencies, big trade deficits, etc.) are quite common in Asia, there is a high risk of contamination. For good reason, therefore, the monetary authorities of various neighboring countries have joined forces with the Thai central bank against a heavy speculative assault by U.S. hedge funds and banks, spending as much as $12 billion buying baht against U.S. dollars, of which they have plenty in their reserves.

For us, these Far Eastern currency upheavals are just another accident that has been waiting to happen. In the March issue of this letter, we have in some detail explained the woes of these countries. While we rightly admire them for their strong economic growth, their massive accumulation of dollar reserves has for years been fueling excessive rates of credit and money growth, fostering serious imbalances in their economies and financial system. To be sure, they are extremely vulnerable.

To defeat the speculators, the Bank of Thailand followed up with informal capital controls by strong-arming local banks and foreign branches not to lend baht to offshore borrowers. Since speculating against a currency implies to borrow it, the speculators were effectively set high and dry. In general, they had to give up with heavy losses.

The next assault is sure to happen. Thailand looks too inviting a target. It depends fully on short-term capital flows to fund its current-account deficit of about $9 billion, or eight percent of GDP. In addition, it will need to raise yet an estimated $63 billion in 1997, including rolling over an estimated $40 billion of short-term debt and the repayment of $9 billion of medium- to long-term debt.

On the other hand, the Bank of Thailand owns dollar reserves of $38 billion. Thus, it has the choice to fight the speculation either by dumping dollars and U.S. bonds from their reserves or with higher interest rates. Given also the unwinding of the yen-carry trade, this speculation might well backfire on the U.S. dollar and the U.S. bond market.

CONCLUSIONS:

U.S. equities and many bourses in Europe soared in the wake of the Fed's decision to hold its federal-funds rate target at 5.5 percent. On Wall Street, the most spectacular gains were in high-tech stocks with previous large short positions. While smaller-cap stocks have in general also improved, the rally has remained most conspicuous in the large caps that dominate the indexes.

Unlike stocks, bonds did not benefit at all from the Fed's abstinence. Maybe, the reason is continuing rate jitters, as investors don't trust the monetary lull. But there are two big clouds: the disruption of the yen-carry trade and of the heavy U.S. bond purchases by foreign central banks.

Global bond markets have most certainly peaked, even though the widely predicted synchronized global growth scenario looks increasingly fragile. What we fear is not accelerating inflation but a slowdown, if not some unwinding of the vast speculative excesses that have underpinned bond and stock markets throughout the world (in some countries, though, more than in others). Most exposed are essentially the U.S. market and the European high-yielders.

The main sources of trouble, as explained in this letter, are the changes and turmoil in the currency markets in Far Eastern Asia, primarily the Japanese yen and the Thai baht. The question is whether the central banks and governments will be able to keep the market under control. Together, they have immense firepower in terms of dollar reserves. But individually, quite a few countries are highly vulnerable, as their short-term liabilities in dollar and yen vastly exceed their reserves.

Additional vulnerability arises from the fact that the region has experienced a drastic slowdown in its foreign trade. Asia's export volume growth was just 2.5 percent in 1996 versus 9.5 percent in 1995 and an annual average of seven percent over the 1990-96 period, reflecting in particular a steep decline in high-tech exports.

It will need no less than a political and economic miracle in France and Germany to secure EMU implementation.

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